

In the Supreme Court of the United States

OCTOBER TERM, 1990

JILL S. KAMEN, PETITIONER

v.

KEMPER FINANCIAL SERVICES, INC., and
CASH EQUIVALENT FUND, INC.

ON WRIT OF CERTIORARI TO THE
UNITED STATES COURT OF APPEALS
FOR THE SEVENTH CIRCUIT

**BRIEF FOR THE SECURITIES AND
EXCHANGE COMMISSION AS AMICUS CURIAE
IN SUPPORT OF PETITIONER**

KENNETH W. STARR
Solicitor General

JOHN G. ROBERTS, JR.
Deputy Solicitor General

MICHAEL R. DREEBEN
Assistant to the Solicitor General
Department of Justice
Washington, D.C. 20530
(202) 514-2217

JAMES R. DOTY
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

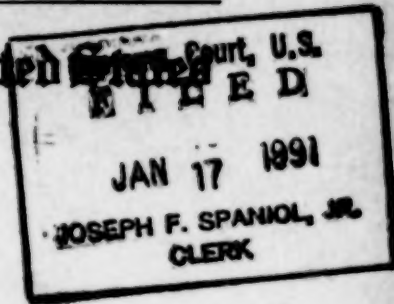
LUCINDA O. MCCONATHY
Assistant General Counsel

RANDALL W. QUINN

BRIAN F. McNALLY

Attorneys

Securities and Exchange Commission
Washington, D.C. 20549



QUESTION PRESENTED

Whether a shareholder alleging a proxy violation under Section 20(a) of the Investment Company Act, 15 U.S.C. 80a-20(a), and seeking relief in favor of the investment company, is required by federal law to make a demand on the directors of the company to bring the action even when such a demand would be futile.

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**BRIEF FOR THE SECURITIES AND
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**INTEREST OF THE SECURITIES
AND EXCHANGE COMMISSION**

The Securities and Exchange Commission is responsible for the administration and enforcement of the federal securities laws, including the Investment Company Act of 1940, 15 U.S.C. 80a-1, *et seq.* Private securities actions provide “‘a most effective weapon in the enforcement’ of the securities laws and are ‘a necessary supplement to Commission action.’” *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985), quoting *J.I. Case Co. v. Borak*, 377 U.S. 426, 432 (1964). The standards governing demand requirements in shareholder deriv-

ative actions under the securities laws often have a significant impact on the disposition of those actions. The Commission has a strong interest, therefore, in the development of correct principles to govern such requirements.

STATEMENT

1. Petitioner Jill S. Kamen is a shareholder of respondent Cash Equivalent Fund, Inc. (Fund), a money market mutual fund registered under the Investment Company Act of 1940, 15 U.S.C. 80a-1, *et seq.* The Fund's investment adviser and manager is respondent Kemper Financial Services, Inc. (KFS). Petitioner filed a complaint on behalf of the Fund in the United States District Court for the Northern District of Illinois, alleging violations of two provisions of the Act by KFS. As amended, the complaint alleges that KFS charged the Fund excessive fees, in violation of Section 36(b) of the Act, 15 U.S.C. 80a-35(b). The complaint also alleges that KFS caused the Fund's directors to distribute a proxy statement, soliciting shareholder approval to continue the investment management agreement between KFS and the Fund, that was materially misleading in violation of Section 20(a) of the Act, 15 U.S.C. 80a-20(a).¹ Pet. App. 33a, 85a-93a.

Petitioner's proxy claim alleges that the proxy statement misleadingly compared the fees and services required under KFS's agreement with the Fund to those required under KFS's agreement with another fund for which it acted as manager, the Kemper Money Market Fund, Inc. (MM). According to the complaint, although the proxy statement accurately described the services rendered to the Fund and MM as being similar, it misleadingly described the fees charged to MM. The resulting impression, the complaint alleges, was that KFS's fees to MM

¹ Section 20(a) of the Act, 15 U.S.C. 80a-20(a), is virtually identical to the proxy provision of the Securities Exchange Act of 1934, Section 14(a), 15 U.S.C. 78n(a). Rule 20a-1 under the Act, 17 C.F.R. 270.20a-1, adopts the rules promulgated under Section 14(a) of the Exchange Act, 17 C.F.R. 240.14a-1.

were as high or higher than those to the Fund, when in fact KFS's fees to MM were substantially lower. The complaint further alleges that as a result of the misleading solicitation, the Fund's shareholders approved KFS's management agreement, thus causing damage to the Fund and its shareholders. As relief, the complaint requests the payment of damages to the Fund. Pet. App. 90a-91a, 93a.

The complaint also alleges that petitioner had not made a demand on the Fund or its directors to maintain the proxy action because demand would have been futile. In support of the assertion of futility, the complaint states that three of the ten directors had a personal financial interest in KFS; that the Fund's president had served as KFS's president and owned stock in its parent; and that the disinterested directors currently receive an aggregate of \$300,000 annually for serving as directors of Kemper group funds. The complaint also asserts that the proxy statement was solicited by the Fund's directors, whose culpability would tend to be established if this suit were successful, and that demand would be tantamount to asking the directors to sue themselves. The complaint further alleges that KFS controlled the Fund and its directors, and that the directors and the Fund had manifested their opposition to the action by moving to dismiss the original complaint. Finally, the complaint alleges that requiring demand would be inconsistent with the policies underlying Section 20 of the Act. Pet. App. 86a, 92a-93a.

2. The district court dismissed the Section 20 claim on the ground that petitioner's allegations of the futility of demand failed to comply with the requirements of Rule 23.1 of the Federal Rules of Civil Procedure.² Pet. App. 46a-56a. Examining the complaint in light of fed-

² Rule 23.1 applies to shareholder derivative actions and requires a shareholder to allege "with particularity" his efforts, if any, to obtain the action desired from the directors, and "the reasons for the [shareholder's] failure to obtain the action or for not making the effort."

eral cases addressing the futility exception, the court concluded that petitioner did not particularize sufficient reasons for failing to make demand on the Fund's directors. Rather, petitioner's "generalized allegations" of futility "have been consistently rejected by the courts as inadequate under Rule 23.1." Pet. App. 51a.³

3. The court of appeals affirmed the dismissal of petitioner's proxy claim.⁴ Although agreeing with the district court that petitioner's allegations of futility were inadequate, Pet. App. 6a, 17a, the court of appeals went on to formulate a new rule, as a matter of federal common law, that demand on directors is a universal requirement in cases in which shareholders bring derivative actions under a federal statute; futility never excuses demand. *Id.* at 20a. The court said: "[C]laims of futility should be tested by *making* the demand rather than by arguing about hypotheticals. If the firm declines to sue, the court can decide whether the board's decision is entitled to respect under state corporate law." *Ibid.*

In explaining its holding, the court acknowledged that it is theoretically correct that demand should be excused if the courts would not honor the board's decision not to sue. But the court observed that in practice it is difficult to resolve contested claims that demand would be a futile gesture. Pet. App. 14a-15a. Claims of futility, the court thought, are hotly contested because of the principle embraced by some States that when a shareholder makes a demand, review of the board's decision not to sue is conducted under the highly deferential business judgment standard. *Id.* at 12a. The court rejected

³ The court also dismissed petitioner's claim under Section 36(b) of the Act, on the basis that petitioner was not an adequate class representative. Pet. App. 73a-77a, 79a, 84a.

⁴ It reversed the dismissal of petitioner's Section 36(b) claim, Pet. App. 22a-29a, but rejected her request for a jury trial. *Id.* at 29a-32a. Because the grant of certiorari is limited to the first question presented by the petition, no issue under Section 36(b) is before this Court.

that principle, however, concluding that "when the demand requirement comes from federal common law, the making of a demand does not affect the standard with which the court will assess the board's decision not to sue." *Id.* at 13a. Having "sever[ed] the link between demand and the standard of review," the court concluded that the difficulties in determining whether demand is futile "are not worth incurring." *Id.* at 14a.

In formulating these principles, the court declined to consider whether proxy claims are properly characterized as derivative actions at all for purposes of Rule 23.1, because that point had not been raised by petitioner. Pet. App. 6a-7a. The court also noted that it could be argued that demand requirements should be drawn from state corporate law, but it declined to consider that argument because petitioner did not rely on the law of Maryland, where the Fund is incorporated, until filing her reply brief. *Id.* at 8a-9a. Finally, the court recognized that Supreme Court decisions from the early years of the century arguably established a federal futility exception to the demand requirement. *Id.* at 18a, citing *Doctor v. Harrington*, 196 U.S. 579 (1905); *Delaware & Hudson Co. v. Albany & Susquehanna R.R.*, 213 U.S. 435, 447 (1909). But the court of appeals concluded that those decisions had either been overruled sub silentio, or were out of step with contemporary developments in corporate law; accordingly, the court concluded that neither case prevented it from abandoning the futility exception as a matter of federal common law. Pet. App. 20a.

SUMMARY OF ARGUMENT

A. A claim that a misleading proxy statement was used to solicit shareholder votes is a direct shareholder action that does not implicate the requirement of demand applicable to derivative actions. The essence of a derivative action is the shareholder's assertion, on behalf of the corporation, of a legal claim that the corporation has against the directors, officers, or third parties. The demand requirement exists in such cases to preserve the primacy of corporate directors in managing the enterprise's affairs. But where the underlying claim belongs directly to shareholders, demand is not necessary. Cf. *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523 (1984). That is the situation in this case.

Petitioner's action asserts a violation of the *shareholders'* right to receive truthful and complete information about questions presented to shareholders for a vote. It follows from the purpose of federal proxy regulation—to protect the shareholders' right to honest disclosure—that a shareholder's proxy action does not assert a claim that belongs to the corporation. Accordingly, the demand requirement, and the body of principles designed to determine when demand is excused, does not apply in this context.

B. On the assumption that a demand requirement is at issue here, the court of appeals erred in formulating a universal demand requirement as a matter of federal common law, thus abolishing any exception for cases in which demand would be futile. The issue in this case is governed by *Burks v. Lasker*, 441 U.S. 471 (1979), which held that rules establishing the powers of corporate directors are generally drawn from state law, unless those rules are inconsistent with federal policy. *Burks* involved a core issue of corporate law—the power of disinterested directors to terminate derivative litigation. Here too, the issue of demand on directors is a core issue of corporate law that should be controlled, absent a conflict with federal policy, by state law.

The law of Maryland, the State of the Fund's incorporation, recognizes a futility exception to the demand requirement. Nothing in the policy of the Investment Company Act is inconsistent with a futility exception. Although the Act creates disinterested directors who serve a valuable watchdog function in investment companies, no federal policy is frustrated by excusing demand on a board of directors when it would be futile.

The court of appeals' federal demand requirement is also objectionable on its own terms. Not only would it complicate the selection of state rules applicable to the directors' efforts to terminate derivative actions, it could dilute the standards under which those efforts are reviewed by the courts, contrary to federal policy. Those difficulties provide added reasons for adhering to the approach of *Burks v. Lasker* of borrowing state law on internal corporate affairs unless federal policy requires otherwise.

ARGUMENT

THE COURT OF APPEALS ERRED IN FORMULATING A UNIVERSAL DEMAND REQUIREMENT AS A MATTER OF FEDERAL COMMON LAW

A. Shareholder Allegations Of Proxy Violations Are Properly Characterized As Direct Actions

Before applying any demand requirement, the threshold inquiry is whether a particular claim is a derivative action within the meaning of Rule 23.1 of the Federal Rules of Civil Procedure. The rule applies to "a derivative action brought by one or more shareholders * * * to enforce a right of a corporation * * *, the corporation * * * having failed to enforce a right which may properly be asserted by it[.]" Fed. R. Civ. P. 23.1 (emphasis added). In our view, a shareholder's proxy suit asserts a legal claim belonging to the shareholder himself, and is not subject to a requirement that the share-

holder must make demand on the directors as a prerequisite to maintaining the action.⁵

1. Shareholder derivative actions originated in equity as the consolidation of two distinct claims: first, the claim by a shareholder that the corporation has failed to assert a corporate right, and, second, the claim by the corporation against the directors, officers, or third parties who are liable to it. See *Hawes v. Oakland*, 104 U.S. 450, 452 (1882); *Ross v. Bernhard*, 396 U.S. 531, 534-535 (1970); *Arcanson v. Lewis*, 473 A.2d 805, 811 (Del. 1984); 13 W. Fletcher, *Cyclopedia of the Law of Private Corporations* §§ 5941.1, 5946 (1984 rev. ed. & Supp. 1990); Block, Radin & Rosenzweig, *The Role of the Business Judgment Rule in Shareholder Litigation at the Turn of the Decade*, 45 Bus. Law. 469, 470-471 (1990). Because the purpose of the action is to allow shareholders to protect corporate rights, "[t]he heart of the action is the corporate claim." *Ross v. Bernhard*, 396 U.S. at 539. See *Daily Income Fund, Inc. v. Fox*, 464 U.S. 523, 528-529 (1984); *Cohen v. Beneficial Loan Corp.*, 337 U.S. 541, 548 (1949) (in a derivative action, the shareholder steps into the corporation's shoes and seeks in its right "the restitution he could not demand in his own"); *Meyer v. Fleming*, 327 U.S. 161, 167 (1946) (derivative suit "enforce[s] a corporate claim * * * where the management * * * declines to take the proper and necessary steps to assert the rights which the corporation has").

⁵ Petitioner's complaint alleges that her action is brought on behalf of the Fund, Pet. App. 86a, and she conceded the applicability of Rule 23.1 in the court of appeals. Consequently, that court noted but did not address the issue whether the action is properly treated as direct in nature. Pet. App. 7a. Although the petition does not challenge the applicability of Rule 23.1, the question presented is framed broadly enough to encompass that issue, see Sup. Ct. R. 14.1(a), and the Court has discretion to address it as an "antecedent" question that is "ultimately dispositive of the present dispute." *Arcadia v. Ohio Power Co.*, 111 S. Ct. 415, 418 (1990).

The demand requirement is integrally tied to the character of a derivative action as the assertion of a corporate claim. It reflects the principle that the management of the corporation is entrusted to its directors, not its shareholders. As the Court explained in *United Copper Securities Co. v. Amalgamated Copper Co.*, 244 U.S. 261, 263 (1917), "[w]hether or not a corporation shall seek to enforce in the courts a cause of action for damages is, like other business questions, ordinarily a matter of internal management and is left to the discretion of the directors[.]" Directors, exercising business judgment, "may sometimes properly waive a legal right vested in the corporation in the belief that its best interests will be promoted by not insisting on such right." *Corbus v. Alaska Treadwell Gold Mining Co.*, 187 U.S. 455, 463 (1903), see also *Ashwander v. TVA*, 297 U.S. 288, 343 (1936) (Brandeis, J., concurring); *Delaware & Hudson Co. v. Albany & Susquehanna R.R.*, 213 U.S. 435, 446 (1909).

But the purposes of the demand requirement define the limits of its application. For example, if the corporation is not authorized to assert a particular cause of action, shareholders need not make a demand on the directors to do so. In *Daily Income Fund, Inc. v. Fox*, *supra*, the Court applied that principle, holding that the provisions of Rule 23.1 are inapplicable to a claim by a security holder under Section 36(b) of the Investment Company Act, 15 U.S.C. 80a-35(b), that an investment adviser has breached its fiduciary duty with respect to the receipt of compensation from the company. The Court explained that Section 36(b) expressly authorizes security holders and the SEC to enforce such claims, but does not authorize the investment company itself to do so. Since the claim is not one that the company could assert, it is not a derivative action under Rule 23.1. 464 U.S. at 534-542. An analogous principle applies if the cause of action arises not from the invasion of the corporation's legal rights, but from the invasion of the shareholders' legal rights. In

that setting, the cause of action is not "derived from the corporation," *Cohen v. Beneficial Loan Co.*, 337 U.S. at 549, and is not properly subject to its control. Cf. *Smith v. Sperling*, 354 U.S. 91, 99 (1957) (Frankfurter, J., dissenting) (contrasting derivative action from the "wholly different situation * * * which arises when the corporation is charged with invasion of the stockholder's independent right").

2. In light of those principles, a shareholder's claim based on a proxy violation is a direct action that does not implicate the requirement of demand. A proxy claim asserts a violation of a shareholder's own right to truthful and complete information in communications used to solicit his vote. Section 14(a) of the Securities Exchange Act of 1934, 15 U.S.C. 78n(a)—the original provision in the securities laws regulating the solicitation of proxies—was intended to "control the conditions under which proxies may be solicited with a view to preventing the recurrence of abuses which [had] frustrated the free exercise of the voting rights of stockholders." H.R. Rep. No. 1383, 73d Cong., 2d Sess. 14 (1934). The provision's purpose is to guarantee that persons soliciting proxies will provide "an explanation to the stockholder of the real nature of the questions for which authority to cast his vote is sought." S. Rep. No. 792, 73d Cong., 2d Sess. 12 (1934). See *J. I. Case Co. v. Borak*, 377 U.S. 426, 431 (1964); *Mills v. Electric Auto-Lite Co.*, 396 U.S. 375, 381 (1970). In 1940, Congress likewise empowered the SEC to prescribe proxy-solicitation rules for investment companies "as necessary or appropriate in the public interest or for the protection of investors." 15 U.S.C. 80a-20(a) (emphasis added). See S. Rep. No. 1775, 76th Cong., 3d Sess. 17 (1940).

It follows from the purpose of federal proxy regulation that when a shareholder's vote is secured through a false or misleading proxy statement, it is the personal right of the shareholders to "[f]air corporate suffrage" that is violated. H.R. Rep. No. 1383, *supra* at 13. When the

shareholder sues to vindicate that right, the action asserts a direct infringement of federal requirements enacted for his benefit; the claim does not "derive" from an invasion of legal rights belonging to the corporation. Accordingly, the conceptual underpinning for requiring demand in a derivative case—that the right in question belongs to the corporation—is absent.⁶

It would be deeply ironic if directors could secure the shareholders' votes through a misleading proxy statement, and then insist that a shareholder seeking redress make demand on the directors before suing. Cf. *Galef v. Alexander*, 615 F.2d 51, 63 (2d Cir. 1980) (purposes of the proxy provision "would quite clearly be frustrated" if a director sued for proxy violations "were permitted to cause the dismissal of that action simply on the basis of his judgment that its pursuit was not in the best interests of the corporation").⁷ Even if the directors could not obtain the outright dismissal of a proxy claim in all instances when the shareholder did not make demand, the demand requirement would impose an unwarranted procedural hurdle with potential delay and additional costs that would obstruct the shareholders' assertion of their right to truthful proxy statements.

Characterizing a proxy claim as a direct action does not deprive directors of means to oppose a suit they believe to be contrary to the shareholders' interests.⁸ The

⁶ The corporation may also bring a proxy claim in certain circumstances, but in such a case, the claim is properly viewed as deriving from a violation of the shareholders' rights. See *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. 1, 32 & n.21 (1977).

⁷ In *Galef*, the Second Circuit held that federal policy precludes defendant directors in a Section 14(a) action from summarily dismissing that claim pursuant to the business judgment rule. 615 F.2d at 64; see *id.* at 64 n.20 (reserving the issue of whether a committee of disinterested directors could, consistent with federal policy, terminate a proxy suit on business judgment grounds).

⁸ Nor does it prevent investment company directors from fulfilling their statutory duties. Although the Act requires disinterested

corporation is frequently named as a nominal defendant in proxy litigation to obtain complete relief, and, where it is not, it may intervene as a party under the customary standards for intervention. In that capacity, the corporation may urge that the complaint lacks merit, or that the relief sought would not be "in the best interests of the shareholders as a whole." Cf. *Mills v. Electric Auto-Lite Co.*, 396 U.S. at 388.

Nor should the type of relief sought by a shareholder's proxy action affect the analysis. To be sure, a proxy action may loosely be called derivative—"in the broad sense of that word"—if it seeks a monetary recovery in the corporation's favor. See *Fox*, 464 U.S. at 535 n.11. Indeed, in *J. I. Case Co. v. Borak*, 377 U.S. at 431, the Court described the implied private right for proxy violations as including derivative as well as direct claims.⁹ That description reflects the hybrid aspect of a proxy action like petitioner's: the action asserts a violation of shareholder rights, but seeks recovery for the benefit of the corporation.¹⁰ But, as *Fox* illustrates, not all suits

directors who serve as "watchdogs" for investors, see *infra* at 19, nothing in the Act or its policies empowers those directors to control direct shareholder actions.

⁹ The Court has since made clear that the cause of action recognized in *Borak* flows from the violation of all of the shareholders' rights, and that "[t]he *Borak* Court was thus focusing on all stockholders—the owners of the corporation—as the beneficiaries" of the proxy provision. *Piper v. Chris-Craft Indus., Inc.*, 430 U.S. at 32 & n.21. *Borak*'s characterization of the action before it as "derivative" did not rely on the factors governing whether an action is considered derivative under traditional concepts, see *Hawes v. Oakland*, 104 U.S. at 460, or contemporary jurisprudence, see *Daily Income Fund, Inc. v. Fox*, *supra*. Above all, nothing in *Borak* indicates that the Court had in mind the corporate management issues underlying the demand requirement as applied to true derivative actions. At most, the relief authorized by *Borak* is derivative; the underlying claim is not. Cf. *Mills*, 396 U.S. at 388 (discussing "derivative" relief).

¹⁰ Of course, a particular proxy action may seek direct damages to be paid to the shareholder plaintiffs, and have no element that

seeking a recovery for the benefit of the corporation qualify as derivative actions in the relevant sense. "[T]he provisions [of Rule 23.1] regarding demand assume a lawsuit that could be controlled by the corporation's board of directors." *Fox*, 464 U.S. at 533. When the legal claim could not properly be controlled by the board, the rules developed to protect the directors' primacy in overseeing corporate affairs do not apply.

B. Demand and Futility Requirements For Shareholder Derivative Actions Under The Investment Company Act Should Be Drawn From State Law

On the assumption that petitioner's action is viewed as a derivative one that implicates the demand requirement, the court of appeals erred in its novel formulation of a federal demand rule. Asserting the power to make federal common law, the court of appeals imposed a universal demand requirement in all derivative actions arising under a federal statute, thereby eliminating the traditional exception for futility. In our view, the court of appeals should not have confronted the demand question armed solely with federal common law, without initial consultation of state corporate law. In this case, as in *Burks v. Lasker*, 441 U.S. 471 (1979), state law furnishes the applicable rule unless it conflicts with federal policy.

1. State law supplies the demand requirements applicable to federal derivative actions, unless state requirements are inconsistent with federal policy

Because petitioner's cause of action arises under a federal statute, federal law governs the incidents of the action; "state law does not operate of its own force." *Burks*

could be viewed as derivative. See, e.g., *Virginia Bankshares, Inc. v. Sandberg*, No. 89-1448 (argued Oct. 9, 1990). Other actions may simultaneously seek, as alternative relief, the direct payment of damages to shareholders and other forms of relief for the corporation's benefit. See *Mills*, 396 U.S. at 388-389. A rule distinguishing proxy claims by the form of relief sought, requiring demand for some but not for others, would produce nothing but confusion.

v. *Lasker*, 441 U.S. at 480; *Sola Elec. Co. v. Jefferson Elec. Co.*, 317 U.S. 173, 176 (1942); *D'Oench, Duhme & Co. v. FDIC*, 315 U.S. 447, 471-472 (1942) (Jackson, J., concurring). But federal law may look to state sources to derive the appropriate rule of decision, particularly in an area in which the States enjoy primary responsibility. See *Reconstruction Finance Corp. v. Beaver County*, 328 U.S. 204, 210 (1946) (applying state property law); *De Sylva v. Ballentine*, 351 U.S. 570, 580 (1956) (applying state domestic relations law). The substantive law of corporations belongs to this category. Although federal principles may, "where the facts require[], control the appropriateness of redress despite the provisions of state corporation law," *J. I. Case Co. v. Borak*, 377 U.S. at 434, "the first place one must look to determine the powers of corporate directors is in the relevant State's corporation law." *Burks*, 441 U.S. at 478. See *Cort v. Ash*, 422 U.S. 66, 84 (1975); cf. *Milwaukee v. Illinois*, 451 U.S. 304, 313-314 (1981).

In *Burks v. Lasker*, the Court considered which law—state or federal—applies when an independent committee of directors seeks to terminate a shareholder's derivative claim under the Investment Company Act.¹¹ 441 U.S. at 475. The Court held that the issue should be resolved by applying a two-step analysis. *First*, because "[c]or-

¹¹ In *Burks*, shareholders of an investment company filed a derivative action against the company's directors and its investment adviser, alleging that the defendants had breached their duties under the Act and the common law by purchasing a particular issuer's commercial paper without making an adequate independent investigation of its quality and safety. 441 U.S. at 473-474. In response to the action, the board appointed a quorum of independent directors to determine the company's position in the case. Following an investigation, the committee determined that the suit was contrary to the shareholders' interest, and sought its dismissal. *Id.* at 474. The court of appeals held that the Investment Company Act deprived disinterested directors of the power to terminate such derivative litigation. *Id.* at 475. This Court reversed, holding that federal law had a narrower sweep. *Id.* at 480-485.

porations are creatures of state law * * * and it is state law which is the font of corporate directors' powers," that body of law should be consulted as an initial matter. *Id.* at 478. Federal law for corporations, the Court explained, "is largely regulatory and prohibitory in nature—it often limits the exercise of directorial power, but only rarely creates it." *Ibid.* Consequently, "congressional legislation is generally enacted against the background of existing state law" which is not displaced "simply because a plaintiff's cause of action is based upon a federal statute." *Ibid.* *Second*, a court must determine whether state law permits action that is prohibited by federal law or is inconsistent with underlying federal policy; if it does, federal policy prevails. *Id.* at 479. This "'consistency' test guarantees that '[n]othing that the state can do will be allowed to destroy the federal right.'" *Id.* at 480, quoting *Board of County Comm'rs v. United States*, 308 U.S. 343, 350 (1939).¹²

The analysis in *Burks* governs the issue of director demand in this case. The demand requirement, like the authority of disinterested directors to terminate derivative litigation, expresses a policy with respect to the management of a corporation's internal affairs. The pre-

¹² The approach marked out in *Burks* contrasts with the approach for choosing between state and federal law in selecting a statute of limitations for a federal claim that lacks an express limitations period. See SEC Amicus Brief, *Lampf Pleva Lipkind Prupis & Petigrow v. Gilbertson*, No. 90-333 (to be argued Feb. 19, 1991) (arguing that a five-year federal limitations period should be applied to implied actions under Rule 10b-5). (We have provided copies of our brief in *Lampf* to the parties here.) The different test prescribed in *Burks* can be explained as a response to the characteristic relationship between state and federal law in corporate matters: federal law generally imposes restrictions on internal management, rather than providing "the source of authority for managerial power." 441 U.S. at 478. In contrast, there is no similar division of responsibilities between the state and federal governments in devising statutes of limitations.

eminent reason for requiring demand is to further "a principle basic to corporate organization, that the management of the corporation be entrusted to its board of directors." Note, *The Demand and Standing Requirements in Stockholder Derivative Actions*, 44 U. Chi. L. Rev. 168, 171 (1976); *Hawes v. Oakland*, 104 U.S. at 462; *Daily Income Fund, Inc. v. Fox*, 464 U.S. at 530. Demand may also serve to stimulate alternative dispute resolution, to allow the corporation to assert the derivative claim directly, and to discourage "strike" suits. See D. DeMott, *Shareholder Derivative Actions: Law and Practice* § 5:03, at 26-27 (1987); Block, Radin & Rosenzweig, *supra*, at 472-473; *Aronson v. Lewis*, 473 A.2d 805, 811-812 (Del. 1984); 13 W. Fletcher, *supra*, § 5963. Each of those reasons reflects substantive policy choices about the internal management of corporate affairs. Indeed, in the law of some States, the demand requirement is interwoven with the power of disinterested directors to terminate derivative litigation. See *Spiegel v. Buntrock*, 571 A.2d 767 (Del. 1990). Accordingly, state requirements with respect to demand, which are found in the law of every State, see D. DeMott, *supra*, § 5:03, at 23, should be given effect in federal derivative litigation in the absence of a conflict with federal policy.¹³

Rule 23.1 of the Federal Rules of Civil Procedure does not require courts to fashion a body of federal law to

¹³ As this Court noted in *Fox*, 464 U.S. at 530-531, the demand requirement that was established as a matter of federal common law in *Hawes v. Oakland*, *supra*, and later codified in Equity Rule 94, 104 U.S. ix-x (1882), served the additional purpose of preventing the collusive manufacture of diversity jurisdiction. That policy, along with other policies designed to reduce federal court adjudication of state claims, continues to be reflected in Rule 23.1. *Fox*, 464 U.S. at 531 n.6. But the major purpose of the demand requirement is to promote substantive policies regarding the litigation of corporate claims. *Id.* at 532-533; *id.* at 544 n.2 (Stevens, J., concurring) ("It cannot be doubted that [the demand] requirement, designed to improve corporate governance, is one of substantive law.").

govern demand.¹⁴ On its face, the Rule does not establish a specific requirement of demand, but simply requires that "[t]he complaint shall * * * *allege* with particularity the efforts, if any, made by the plaintiff to obtain the action the plaintiff desires from the directors * * * and the reasons for the plaintiff's failure to obtain the action or for not making the effort" (emphasis added). The Rule does not discuss the consequences of omitting to make demand, nor does it address when, if ever, demand is excused. Its purpose is to establish a pleading requirement, with substantive standards to be supplied from another source. *Starrels v. First Nat'l Bank*, 870 F.2d 1168, 1170 (7th Cir. 1989). Indeed, construing Rule 23.1 to create substantive standards for demand would conflict with the Rules Enabling Act, 28 U.S.C. 2072, which provides that rules of civil procedure may not "abridge, enlarge or modify any substantive right." See *Mississippi Publishing Corp. v. Murphee*, 326 U.S. 438, 445-446 (1946); *Sibbach v. Wilson & Co.*, 312 U.S. 1, 14 (1941); cf. *Bangor Punta Operations, Inc. v. Bangor & A. R.R.*, 417 U.S. 703, 708 n.4 (1974).¹⁵

¹⁴ In *Fox*, the Court reserved this issue of whether Rule 23.1 establishes a demand requirement as a matter of federal procedure. 464 U.S. at 532 n.8; see also *id.* at 543-544 (Stevens, J., concurring) (arguing that Rule 23.1 "concerns itself solely with the adequacy of the pleadings; it creates no substantive rights").

¹⁵ As the court of appeals noted (Pet. App. 18a-20a), this Court developed a demand requirement, and exceptions to it, in a line of cases decided before *Erie R.R. v. Tompkins*, 304 U.S. 64 (1938). Whether or not those cases can be distinguished as the court of appeals suggested—and whether, after *Erie*, they carry weight apart from their persuasive force, see *Clearfield Trust Co. v. United States*, 318 U.S. 363, 367 (1943)—our essential point is this: this Court's decision in *Burks v. Lasker*, *supra*, makes clear that those early decisions do not control the analysis of what is required, in a federal action, with respect to core issues of corporate law such as demand. Likewise, we do not believe that the court of appeals was justified in overlooking state law because the issue was not raised until the reply brief. The court evidently appreciated the relevance

2. Maryland law, which excuses demand when it would be futile, is not inconsistent with the policy of the Investment Company Act

Applying the approach established in *Burks*, the first step is to select a body of state law. Here, the relevant law is that of Maryland, the State in which the Fund is incorporated. See *CTS Corp. v. Dynamics Corp.*, 481 U.S. 69, 89 (1987). Maryland law does not require that demand be made in all derivative actions; rather, it embodies a traditional exception that demand is excused if it would be futile. See *Parish v. Maryland & Virginia Milk Producers Ass'n*, 250 Md. 24, 81-84, 242 A.2d 512, 544-545 (1968).¹⁶

The second step is to measure the requirements of state law against federal policy. In our view, nothing in the Act overrides Maryland's recognition of a futility exception to making demand. To begin with, the Act contains no express provision requiring shareholders to make demand on the directors prior to bringing a derivative action. In contrast, Congress created a demand requirement for actions under Section 16(b) of the Securities Exchange Act of 1934, 15 U.S.C. 78p(b), and made Section 16(b) applicable to closed-end investment companies.¹⁷ 15 U.S.C. 80a-29(f). Cf. *General Motors Corp.*

of *Burks* in this context, and at the very least should not have crafted a generally applicable rule of federal common law on the basis of a procedural peculiarity of the case before it.

¹⁶ Currently, the majority of investment companies are organized in Maryland or Massachusetts. Massachusetts, like Maryland, recognizes a futility exception. See *Houle v. Low*, 407 Mass. 810, 813 n.3, 556 N.E.2d 51, 53 n.3 (1990). We express no view on how Maryland applies its futility exception; that issue is one for the lower courts. Compare *Burt v. Danforth*, 742 F. Supp. 1043, 1047-1049 (E.D. Mo. 1990) (finding that Maryland futility exception excuses demand more readily than federal law) with *Zimmerman v. Bell*, 585 F. Supp. 512, 514 (D. Md. 1984) (treating Maryland and federal futility exceptions as equivalent).

¹⁷ Section 16(b) provides that a shareholder may bring an action in behalf of the issuer to recover certain short-swing profits "if the

v. *United States*, 110 S. Ct. 2528, 2532 (1990). Nor is Maryland's recognition of a futility exception inconsistent with the policies of the Act. Indeed, it would be anomalous to conclude that the Act's policies impose greater restrictions on investment company shareholders than are imposed on other shareholders in publicly held companies, as the Act was intended to fortify, not undermine, shareholder protection. See 15 U.S.C. 80a-1(b) (2).

The Act does rely heavily on disinterested directors to protect shareholder interests, see *Daily Income Fund, Inc. v. Fox*, 464 U.S. at 536-537; *Burks v. Lasker*, 441 U.S. at 470-471. But that reliance does not imply a requirement of universal demand. The Act requires that 40% of the company's board consist of independent directors who are neither "affiliated" nor "interested" persons as defined in the Act, 15 U.S.C. 80a-2(a)(19), 80a-10(a), and entrusts those directors with a variety of responsibilities, including the review and approval of the investment adviser and principal underwriter's contracts, 15 U.S.C. 80a-15(c), the appointment of directors to fill certain vacancies, 15 U.S.C. 80a-16(b), and the selection of the company's outside auditor, subject to shareholder ratification, 15 U.S.C. 80a-31(a).

But "[a]ttention must be paid as well to what Congress did not do." *Burks*, 441 U.S. at 483. Although Congress intended the independent directors to serve as "'watch-dogs' to protect shareholder interests," *id.* at 485, it did not give directors absolute power; rather, Congress also gave shareholders an important voice in company affairs. It is particularly relevant to the proxy claims here that the Act requires the initial investment advisory agreement to be approved not only by the disinterested direc-

issuer shall fail or refuse to bring such suit within sixty days after request or shall fail diligently to prosecute the same thereafter." See also *Cramer v. General Tel. & Elec. Corp.*, 582 F.2d 259, 276 n.22 (3d Cir. 1978) (board's decision not to sue does not preclude subsequent shareholder action), cert. denied, 439 U.S. 1129 (1979).

tors, but also by "the vote of a majority of the [company's] outstanding voting securities." 15 U.S.C. 80a-15(a) and (c). In addition, the Act identifies several significant business changes that cannot be made without a similar level of shareholder approval. 15 U.S.C. 80a-13(a).¹⁸ Indeed, in the critical area of policing against fiduciary breaches by the investment adviser involving compensation, Congress determined to rely exclusively on shareholders and the SEC, not the disinterested directors, to bring suit to safeguard shareholder interests. 15 U.S.C. 80a-35(b); *For*, 464 U.S. at 534-535. These inroads on what would normally be management prerogatives reveal that Congress did not intend to leave the protection of shareholder rights entirely in the hands of the disinterested directors. Rather, Congress carefully strengthened the role of disinterested directors in certain quite specific ways, and limited the board's authority in others. It is reasonable to assume that where Congress did not see fit to act, the background rules of state corporate law ordinarily continue to operate.

In our view, no policy found in the statutory scheme dictates a displacement of the traditional futility exception by a universal demand requirement. The law of Maryland, like that of most other jurisdictions, recognizes that demand generally fulfills valuable corporate purposes, but occasionally plays no useful role in regulating derivative claims. It is not necessary to further the policies of the Act that Maryland law be supplanted by a federal rule.

¹⁸ These include a change in classification from a diversified to a nondiversified company; the borrowing of money, issuance of senior securities, or purchase or sale of commodities or real estate not in accordance with the company's registration statement; the deviation from policy with respect to investment in an industry or group of securities as set forth in the registration statement, or from any policy deemed fundamental by the company (see 15 U.S.C. 80a-8(b)(3)); or the cessation of being an investment company. 15 U.S.C. 80a-13(a)(1) to (4).

3. *The court of appeals' federal demand requirement is unworkable, and, if not properly restricted, could infringe shareholder rights under the Investment Company Act*

The court of appeals purported to formulate a federal universal-demand requirement after "sever[ing] the link between demand and the standard of review" applied to the directors' decision not to sue. In so holding, the court expressed its disagreement with those States that treat the making of demand as having significant consequences for the standard of review. Pet. App. 12a-14a, 20a. But the court's attempt to liberate the demand requirement from the subsequent course of derivative proceedings gives rise to perplexing and unresolved complications. Moreover, the application of a universal demand requirement could, in certain cases, undermine investor protection. Both of those considerations counsel strongly against adoption of the court of appeals' sharp break with state law.

a. In the law of most States, the demand requirement does not exist in isolation; it is part of a larger web of principles for determining when directors can obtain the dismissal of a derivative claim. The law of Delaware well illustrates the interdependence of principles in this area. In Delaware law, there are two categories of derivative cases: those in which demand is required, and those in which it is excused.¹⁹ In "demand required" cases, if a shareholder files a derivative action after the board has rejected his demand, the board's refusal to sue is tested under the deferential standards of the business judgment rule. Under those standards, the board's rejection of de-

¹⁹ Demand is excused if "under the particularized facts alleged," the complaint creates "a reasonable doubt" that "(1) the directors are disinterested and independent" or that "(2) the challenged transaction was otherwise the product of a valid exercise of business judgment." *Aronson v. Lewis*, 473 A.2d at 814; *Pogostin v. Rice*, 480 A.2d 619, 624 (Del. 1984). See Block, Radin & Rosenzweig, *supra*, at 475-480.

mand "will be respected unless it was wrongful." *Zapata Corp. v. Maldonado*, 430 A.2d 779, 784 (Del. 1981). The shareholder must carry the burden of establishing facts to overcome the directors' decision.²⁰ In "demand excused" cases, however, an entirely different standard applies. After the shareholder initiates the derivative action, the board is not ousted of power to terminate it; although self-interested directors cannot act for the board, disinterested directors may still express the corporation's viewpoint that the suit should be dismissed. *Id.* at 785-786.²¹ But if disinterested board members make that determination, their decision is tested against a dual standard: (1) the directors must shoulder the burden of establishing the independence and good faith of their committee, and the reasonableness of its investigation, and (2) the court has discretion to apply its independent business judgment to determine whether dismissal of the action is in the corporation's best interest. *Id.* at 788-789; *Kaplan v. Wyatt*, 499 A.2d 1184, 1192 (Del. 1985).²²

²⁰ Delaware cases state that, where applicable, the business judgment rule protects director decisions absent "gross negligence," and that the directors' decision will be honored "[a]bsent an abuse of discretion." *Aronson v. Lewis*, 473 A.2d at 812 & n.6.

²¹ The usual mechanism is for the board to delegate authority to a committee of disinterested directors, who investigate the claim with the advice of counsel, and determine the corporation's position. This was the approach employed in *Burks v. Lasker*.

²² Delaware's approach has also been followed by several federal courts applying state law. See *Rosengarten v. Buckley*, 613 F. Supp. 1493, 1499-1500 (D. Md. 1985) (Maryland law); *Peller v. Southern Co.*, [1987-88 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 93,714, at 98,311 (N.D. Ga. 1988) (Georgia law); *Abella v. Universal Leaf Tobacco Co.*, 546 F. Supp. 795, 797-800 (E.D. Va. 1982) (Virginia law). See also *Joy v. North*, 692 F.2d 880, 891 (2d Cir. 1982) (construing Connecticut law to adopt Delaware's approach, but also requiring independent review in a demand-excused case of the merits of the decision not to sue), cert. denied, 460 U.S. 1051 (1983); *Alford v. Shaw*, 358 S.E.2d 323, 327-328 (N.C. 1987) (following Delaware approach, but also requiring court to evaluate independ-

The creation of a universal demand requirement, as a matter of federal law, undercuts the application of Delaware's two-tier regime. At best, the elimination of the demand-excused category would be a source of confusion about how to apply that branch of Delaware law. If demand is made and rejected, is the applicable standard the business judgment rule or the *Zapata* two-part test? Does the standard depend on whether demand would have been excused under Delaware law? And who bears the burden of proof? Delaware law supplies no answers to those questions. It eliminates the possibility that a shareholder who makes demand may still assert that demand was excused; if demand is made, the business judgment rule applies. *Spiegel v. Buntrock*, 571 A.2d 767, 777 (1990). The federal universal-demand requirement disregards that "the entire question of demand futility is inextricably bound to issues of business judgment and the standards of that doctrine's applicability." *Aronson v. Lewis*, 473 A.2d at 812.

At worst, the newly minted federal standard would operate to undermine settled state precedents, in needless tension with the holding of *Burks v. Lasker*. Under *Burks*, the authority of disinterested directors to terminate derivative litigation is governed by state law, absent inconsistency with federal policy. But if courts are unable to identify the applicable state rule—as may well happen after a shareholder complies with a federal universal demand requirement—they would necessarily end up improvising new rules to fit particular cases. Not only would that run counter to *Burks*, it also clashes with the chief objective of the Seventh Circuit's rule: to simplify deriva-

ently in all cases the merits of decision not to sue). In contrast, several jurisdictions have adopted procedures providing for less extensive judicial review of the decision not to pursue the suit. See, e.g., *Auerbach v. Bennett*, 47 N.Y.2d 619, 393 N.E.2d 994, 419 N.Y.S.2d 920 (1979); *Gaines v. Haughton*, 645 F.2d 761, 770-772 (9th Cir. 1981) (applying California law), cert. denied, 454 U.S. 1145 (1982). The law is in a state of flux in this field. See D. DeMott, *supra*, §§ 5:04 to 5:06.

tive litigation. Rather than ushering in an era of simplicity, the court of appeals' rule bids fair to entangle derivative suits in a protracted process of searching for rules to bridge the gap between state and federal requirements.

b. The court's universal demand requirement could also have troubling, and, in our view, impermissible, consequences for the enforcement of claims under the Investment Company Act. Although the court of appeals purported not to determine the standard for reviewing the board's decision not to sue after a shareholder makes demand, the court seemed to endorse the view that all litigation decisions by disinterested directors would be reviewed under the deferential standards of the business judgment rule. Pet. App. 10a-11a, 15a, 17a.

The directors' opinion that a derivative action is inimical to the shareholders' best interests may be perfectly valid; the costs of pursuing a particular corporate claim may outweigh the benefits. But the standards for reviewing that determination must be consistent with the purpose of the Investment Company Act to protect shareholders against conflicts of interest by corporate directors. 15 U.S.C. 80a-1(b)(2). The precise standards that should govern are not at issue here, and are a matter covered by state law in the first instance. But we believe that in certain circumstances, shareholders must be able to pursue suits on behalf of their companies even when directors object. See *Burks*, 441 U.S. at 481 ("[P]otential conflicts may justify some restraints upon the unfettered discretion of even disinterested mutual fund directors, particularly in their transactions with the investment adviser."). Simplifying the law of demand is an admirable goal, but it is not a goal that justifies compromising the ability of shareholders to protect themselves, and the corporation, from improper transactions resulting from conflicts of interest.²³

²³ If, contrary to our submission, the Court embraces some formulation of a federal universal-demand requirement, we urge the Court

c. The difficulties with the court of appeals' holding—both in accommodating the federal demand requirement to the surrounding legal rules derived from state law, and in avoiding undue infringement of investor protection—flow from a single source: the court's departure from the framework of analysis established by *Burks v. Lasker*, *supra*. State law governing shareholder derivative actions may be subject to criticism on policy grounds, as the court of appeals thought. Nevertheless, if inadequacies in policy require an overhaul of corporate governance rules, the proper bodies to address that issue, if federal law has not done so, are the legislatures and courts of the States.²⁴ *Burk's* approach "relieves federal courts of the necessity to fashion an entire body of federal corporate law out of whole cloth." 441 U.S. at 480. This case illustrates the wisdom and vitality of that approach.

* * * * *

Petitioner's proxy claim is properly characterized as a direct action that is not subject to a requirement of demand. Alternatively, if a demand requirement does

to make clear that its holding does not dictate application of the business judgment rule, or any particular standard, in reviewing the directors' decision. That issue need not be reached in this case, since no director decision is at issue, and it should be left for another day.

²⁴ The American Bar Association and the American Law Institute have each proposed model corporate law codes that provide for universal demand, but differ as to the appropriate standard of judicial review. The ABA recommends that refusal of demand be reviewed under a business judgment standard, with the burden of proof shifting to the corporation if a majority of the board is not independent. See *Changes in the Model Business Corporation Act—Amendments Pertaining to Derivative Proceedings*, 45 Bus. Law. 1241 (1990). The ALI, in contrast, allows independent judicial review of the board's decision, whether or not a majority is independent. *Principles of Corporate Governance: Analysis and Recommendations* §§ 7.08, 7.10, 7.11 (Tent. Drafts Nos. 8 & 9, 1988 & 1989), reproduced at Block, Radin & Rosenzweig, *supra*, at 501-503. The Commission takes no position on these recommendations.

apply here, Maryland's recognition of a futility exception to demand is controlling. In our view, the initial examination of Maryland law, and its application to petitioner's allegations, should be undertaken by the courts below. Cf. *Burks v. Lasker*, 441 U.S. at 486; *United States v. Kimbell Foods, Inc.*, 440 U.S. 715, 740 (1979).

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted.

KENNETH W. STARR
Solicitor General

JOHN G. ROBERTS, JR.
Deputy Solicitor General

MICHAEL R. DREEBEN
Assistant to the Solicitor General

JAMES R. DOTY
General Counsel

PAUL GONSON
Solicitor

JACOB H. STILLMAN
Associate General Counsel

LUCINDA O. MCCONATHY
Assistant General Counsel

RANDALL W. QUINN

BRIAN F. McNALLY

Attorneys

Securities and Exchange Commission

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